No. 1139 56

In the Supreme Court of the United States

October Term, 1944

Kirby Petroleum Company, petitioner

v.

Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

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CITATIONS

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OPINIONS BELOW

The opinion of the Tax Court (R. 16–22) is reported at 2 T. C. 1258; that of the Circuit Court of Appeals (R. 54–59) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 5, 1945. (R. 66.) The petition for a writ of certiorari was filed on April 9, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer was the owner of the fee simple title to two tracts of land. As to one tract, however, there was an outstanding one-eighth mineral interest. The properties were leased for oil and gas exploration and production, the taxpayer retaining a royalty of one-sixth of all oil produced and saved and being entitled to varying royalties on other minerals. By a separate, contemporaneous agreement, which formed part of the consideration for the lease, the taxpayer became entitled to twenty percent of the net profits earned by the lessees as a result of their operations.

The question is whether the Circuit Court of Appeals erred in holding that the taxpayer was not entitled, under Sections 23 (m) and 114 (b) (3) of the Internal Revenue Code, to a deduction for depletion on its share of the lessees' net profits.

STATUTE AND REGULATIONS INVOLVED

The relevant provisions of the statute and regulations involved are set forth in the Appendix, *infra*.

STATEMENT

The facts in this case were stipulated by the parties (R. 32–48), and were found by the Tax Court as stipulated (R. 17).

Taxpayer owned the fee simple title to two tracts of land except that, as to one tract, a one-

eighth mineral interest was outstanding. (R. 17, 33.) On September 29, 1927, taxpayer entered into a lease with the Humble Oil & Refining Company and the Marland Oil Company of Texas, as lessees. (R. 17, 35–39.) Under the lease, which was for the term of five years and as long thereafter as oil or gas should be produced, the lessees acquired the right of "investigating, exploring, prospecting, drilling and mining for and producing oil, gas and all other minerals." (R. 35.)

The lease contained provisions for the payment of delay rentals in the event that the lessees had not commenced drilling operations in accordance with the provisions of the lease. (R. 36–37.) There were also provisions for the drilling of further wells in the event that dry holes should be drilled prior to the discovery of oil or gas. Also, in the event that oil was discovered on adjacent property, the lessees were obligated to drill offset wells. (R. 37.)

The lease provided that all obligations of the lessees were to be understood as covenants and not as conditions or limitations, and that the breach thereof "shall not work a forfeiture or termination of this lease nor cause a termination or reversion of the estate created hereby * * *". (R. 38.)

The taxpayer received a cash bonus upon the execution of the lease (R. 34) and was entitled to a royalty of one-sixth of the oil produced and

saved, as well as of one-sixth of the amount realized from the sale of gas (one-sixth of 25 percent of the market value thereof in the event that the lessees manufactured gasoline or other products therefrom) (R. 17, 36). Contemporaneous with the making of the lease, the parties executed an agreement (R. 42–48), which formed a portion of the consideration for the lease. (R. 17–18, 33–34.) Under the terms of the agreement, taxpayer was entitled to 20 percent of the "net money profits" realized by the lessees from their operations under the lease. (R. 18, 43.) The agreement provided how the net profits should be calculated and how taxpayer's share should be paid. (R. 18, 43–45, 46.)

During the year 1940, taxpayer received \$26,223.70 as its share of the net profits. In its income tax return for 1940, taxpayer deducted depletion to the extent of 27½ percent of this amount. (R. 18, 33.) The Commissioner's notice of deficiency (R. 9–13) disallowed the depletion deduction on this amount. The taxpayer sought a redetermination of the deficiency before the Tax Court. (R. 4–8.) The Tax Court ruled that the taxpayer was entitled to the depletion deduction (R. 16–22), and entered its decision determining a deficiency in income tax arising out of matters not here in dispute (R. 23). The Circuit Court of Appeals, Judge Hutcheson dissenting, reversed the Tax Court.

ARGUMENT

1. The Government does not oppose the granting of a writ of certiorari in this case. The decision below is in direct conflict with that of the Circuit Court of Appeals for the Ninth Circuit in *Commissioner* v. *Crawford,* decided April 21, 1945, subsequent to the filing of the petition in this case. In addition, a question of importance in the administration of the revenue laws is presented.

The court below held that the taxpayer no longer had a capital investment in the underlying oil and gas to the extent that it had acquired the right to share in the net profits earned by the lessees. Accordingly, the taxpayer was denied a deduction for depletion on the portion of the net profits received.

The decision below rests upon the proposition of law that the acquisition of a right to share in net profits is not consonant with the retention of a proportionate depletable interest in the minerals not yet produced. This proposition was derived by the court below from rulings of this Court, particularly *Helvering* v. *O'Donnell,* 303 U. S. 370; *Helvering* v. *Elbe Oil Land Co.,* 303 U. S. 372; and *Anderson* v. *Helvering,* 310 U. S. 404.

The result reached in *Commissioner* v. *Felix Oil Co.,* 144 F. 2d 276 (C. C. A. 9th), would appear to be in conflict with the fundamental theory on which the present case was decided. However, it may be noted that the decision in the *Felix* case

appears to rest, not on the "practical consequences of the provision for payments",[1] but rather on certain other provisions of the instrument. Because of the uncertainty as to the scope of the *Felix* decision the Commissioner requested the Circuit Court of Appeals for the Ninth Circuit, in *Commissioner* v. *Crawford, supra,* to reconsider its position. In the *Crawford* case, as here, the lessor received a cash bonus and was entitled to oil royalties and, in addition, to a share of the lessees' net profits.

The decision in the *Crawford* case, without referring to or resting on any peculiar provisions of the leasing agreements, concluded that the taxpayer's share of the net profits was her "gross income from the property" on which depletion was to be allowed. While we believe the *Crawford* decision to be erroneous, we recognize that it is in conflict with the decision in the case at bar.

2. In addition to relying upon the asserted conflict between the decision below and that in *Commissioner* v. *Felix Oil Co., supra,* the petitioner contends that the Circuit Court of Appeals in this case disregarded findings of fact made by the Tax Court. (Pet. 4–5, Br. 11, 12–15.) We believe that this contention rests upon a misconception of the decision below.

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[1] *Anderson* v. *Helvering*, 310 U. S. 404, 411.

The facts in this case were stipulated (R. 32–48) and were found by the Tax Court as stipulated (R. 17). The opinion of the Circuit Court of Appeals in no way shows any departure from the facts as found by the Tax Court. Particularly, there is no warrant for the assertion (Pet. 4, 5, Br. 14–15) that the Circuit Court of Appeals treated the contemporaneous agreements as separate transactions while the Tax Court had determined that they were part of one transaction. Nothing in the opinion of the Circuit Court of Appeals suggests that it considered that, because the agreement to pay 20 percent of the net profits to the lessor was embodied in a separate document, it should be treated as a separate transaction or that it would have reached a different result if that agreement had been embodied in the lease. Both the Tax Court and the Circuit Court of Appeals arrived at their respective conclusions without attaching any significance to the fact that there were two documents rather than a single one.

The Circuit Court of Appeals did not differ with the Tax Court on what the facts were, or on what proper factual inferences should be drawn, or on whether the transaction was to be viewed as an integrated one. The disagreement was only on a question of law, namely, the implications properly to be drawn from the decisions of this

Court. Upon an analysis of those decisions, the Circuit Court of Appeals concluded that the taxpayer retained a proportionate depletable interest to the extent that it received a cash bonus and was entitled to royalty payments. To the extent, however, that the taxpayer granted exploitation rights to the lessees in exchange for a share of their net profits, it was ruled that the lessees, not the lessor, must have the depletable interest.

CONCLUSION

We believe that the decision of the court below is correct. Since the decision in this case is in conflict with that of the Circuit Court of Appeals for the Ninth Circuit in *Commissioner* v. *Crawford, supra,* and since the Commissioner of Internal Revenue advises that a question of large importance in the administration of the revenue laws is presented, we do not oppose the granting of the petition for a writ of certiorari in this case.

Respectfully submitted.

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MAY 1945.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument

creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

* * * * *

(26 U. S. C., Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

(26 U. S. C., Sec. 114.)

Treasury Regulation 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (m)-1. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—Section 23 (m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for de-

preciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

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U. S. GOVERNMENT PRINTING OFFICE: 1945